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TAGS: EFIN ECON PGOV TU
SUBJECT: MEETINGS WITH BUDGET AND TAX OFFICIALS

REF: ANKARA

¶1. (Sbu) Summary: Deputy General Manager for Budget Ahmet Kesik described to econoffs the state of play on the 2004 budget, saying there is a TL 7 Quadrillion gap, of which TL 3.7 Quad stems from recent populist measures and 3.3 Quad from lower-than-expected revenues in 2003. Kesik echoed senior GOT officials' claims that the 10 percent across-the-board cut in discretionary spending--proposed in a supplementary budget sent to the Prime Minister--could be implemented without seriously hurting government programs. Kesik admitted, however, that the GOT may have to look to the revenue side as well to close the gap. In separate meetings, the Director General of Revenues and his Deputy described the new strategic plan they are elaborating to achieve more effective tax collection. Both the Revenue and Budget officials claimed that the GOT-proposed reduction in VAT rates--from 18 to 8 percent--on the textile sector would have the (counterintuitive) effect of helping the fiscal situation because textile sector export rebates on VAT exceed collections. End Summary.

Budget Official on Fiscal State of Play:

¶2. (Sbu) In a meeting with econoffs January 28, Ahmet Kesik, Deputy Director General for Budget in the Ministry of Finance, shed some light on the state of play between the GOT and the IMF on the 2004 fiscal situation. According to Kesik, for 2004 there is a TL 7 Quadrillion gap (USD 5.2 Billion) between the primary surplus projected in the IMF program and current estimates. Kesik said that the IMF believes the gap may be higher, but Kesik stood by the GOT's figures. He said that TL 3.7 Quadrillion of the gap arises from the GOT's pension payment and minimum wage increases, according to IMF calculations. (Kesik noted but that GOT officials calculate the cost of these measures at TL 3.4 Quadrillion but he used the Fund's numbers.) The remaining TL 3.3 Quadrillion of the gap comes from the "base effect" of lower-than-expected revenues in 2003. Of the TL 3.3 Quadrillion, Kesik said TL 800 Trillion stemmed from a shortfall in VAT collections on petroleum products, because petroleum prices had not been increased in the second half of 2003, whereas the 2003 budget projected price increases in line with CPI inflation. Likewise, Kesik said the absence of increases in electricity and natural gas prices had contributed to the shortfall.

¶3. (Sbu) To begin bridging the gap, GOT officials have prepared and proposed to the Prime Minister a package of measures worth between TL 3.1 and 3.4 Quadrillion to be included in a supplementary budget. With GOT officials keen to avoid revenue-side measures, the central element of this proposal is an across-the board cut of 10 percent nominal in "discretionary" spending, excluding personnel costs. Kesik claimed that these cuts could be implemented without hurting the substance of government programs. According to Kesik, these expenditure items had been slated to increase roughly 25 percent, i.e. substantially more than projected inflation, such that a 10 percent cut should not be too damaging. Kesik said that the cutbacks include military spending, although a substantial share of military spending is off-budget in the Defense Industry Support Fund. (Under the reform program, however, this Fund will be phased out and all military spending brought on budget by 2007.) So far, the military seems to be accepting the need for the 2004 spending cuts. More broadly, the GOT still needs to work out the total package of compensatory fiscal measures with the IMF to close the remaining gap. Subsequent to the meeting, the press has reported that the GOT will announce an additional TL 3.0

Quadrillion of measures, consisting of TL 1.5 Quadrillion from increased Special Consumption Taxes on fuels and TL 1.0 Quadrillion from a reduction in VAT rates from 18 to 8 percent (See below).

Revenue Issues:

¶4. (Sbu) In subsequent meetings, Director General for Revenues Osman Arioglu and his Deputy, Bulent Tas, echoed Kesik's contention that the GOT would increase revenue if it decreased repeat decreased the VAT rate on textiles from 18 to 8 percent. Note: As reported reftel, IMF officials had expressed skepticism about this proposal. End Note. Kesik said this change would yield between TL 600 and 700 trillion.

¶5. (Sbu) Kesik and revenue officials argued that, because of massive false invoicing, the GOT currently pays out more in textile sector VAT tax rebates than it takes in via textile sector VAT payments. According to the Revenue Directorate's calculations, the textile sector accounts for 43 percent of VAT export rebates, such that the proposed rate reduction would reduce rebates paid out by TL 1.393 Quadrillion. On the collection side, the Directorate attributes only 7 percent of VAT collections to the textile sector, such that the proposed rate reduction would reduce collections by only TL 691 trillion. The net saving of about TL 700 trillion corresponds to the high end of Kesik's range. The Director General went so far as to ask for the USG's help with the IMF on this issue. Comment: While we have no reason to doubt the GDR's estimates, we cannot help wondering why, instead of reducing the VAT rate, the GDR does not crack down on questionable export rebate payments--and underreporting of VAT collections--through enhanced auditing of exporters' rebates and collections. Subsequent to the meetings there have been press reports, anonymously quoting GOT officials, saying they have come up with a package to close the gap, including the VAT rate reduction. Since the IMF has not yet agreed to these measures, GOT officials seem to be deliberately leaking its package as a way to pressure the Fund. End Comment.

Improving Collections and the Unregistered Economy:
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¶6. (Sbu) The two General Directorate of Revenues (GDR) officials explained that a major priority was to improve tax collections, via a campaign to bring the unregistered economy into the formal sector. The GDR officials echoed earlier IMF staff comments that, in Turkey, even large companies conduct some of their operations outside the formal economy. Tas emphasized the key to improving collections is to have a more efficient tax administration. The tax administration reorganization moves (see below) under consideration are designed with improved collections in mind. In addition, some of the specific actions the GDR is considering to improve collections in the short run include a more automatic system for VAT collection at gas stations, a reduction in the threshold above which transactions are required to go through banks, and working with local chambers of commerce to improve compliance. Tas acknowledged that Turkey's history of tax amnesties has not helped collections. In his meeting with econoffs, Kesik noted wryly that, with 70 percent of revenues deriving from indirect taxes, and 92.5 percent of direct taxes deriving from withholding taxes on wages, the GDR really should be able to concentrate on the relatively small remaining tax base to improve tax collections.

Reorganization moves:

¶7. (Sbu) Both Tas and Arioglu expressed their appreciation for the work of the U.S. Treasury tax advisors, who had recently completed their second strategic planning workshop with the GDR. The strategic plan that emerged from the workshop was mentioned by Finance Minister Unakitan in a recent press conference, and the tax advisors told econoff the GDR, and even the Minister seem enthusiastic about it. As part of the plan, the GOT would reorganize tax collection in several key respects. At the local level, tax collection is currently the responsibiltiy of the "Deftedars," i.e. local offices that represent the broad spectrum of Ministry of Finance issues. The reorganization would put tax collection in the hands of local offices responsible only for tax collection and reporting to the GDR. The GDR would also gain more autonomy from the rest of the ministry, being transformed into a tax administration agency. A large taxpayer unit would also be established. The GDR's ideas are receving GOT support so far; however, Tas noted that the

private sector tax advisory body, the "Tax Council" was doing a separate study on the tax administration system.

¶8. (Sbu) Tas explained that the legislative vehicle for the GDR's prosposed changes would be the much broader public administration reform bill, currently being spearheaded from the office of the Prime Minister. The new legislation is expected to be submitted to parliament in late spring or summer. Tas explained that part of the reform would be to reduce the number of bodies doing tax audit work, thereby improving coordination. Currently there are four, of which two are in the Ministry of Finance: the Financial Inspection Board, the Tax Audit Board. The GDR officials noted with pleasure that the U.S. Treasury-facilitated plan basically implements the kind of measures the IMF tax experts desired, such that the IMF recommendations dovetailed with what GDR was already doing.

Overreliance on Indirect Taxes:

¶9. (Sbu) Both Kesik and the GDR offiicals lamented the Turkish state's overreliance on indirect taxation. Kesik noted that the IMF would like to see a shift to more direct taxation, as a means of broadening the tax base without increasing tax rates. Tas remarked that the trend has been for the GOT to raise indirect taxes when revenue was needed because it is easier to do so: the GOT has the authority to increase indirect taxes but has to get parliamentary approval to raise direct taxes.
EDELMAN